COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, FEBRUARY 19, 1999

APPLICATION OF

COLUMBIA GAS OF VIRGINIA, INC.
(Formerly Commonwealth Gas
Services, Inc.)

CASE NO. PUE970455

For general increase in natural
gas rates and approval of
performance-based rate
regulation methodology pursuant
to § 56-235.6 of the Code of
Virginia

# FINAL ORDER

On May 9, 1997, as revised on May 20, 1997, Columbia Gas of Virginia, Inc. (formerly Commonwealth Gas Services, Inc. and hereinafter referred to as "Columbia" or "Company") filed a complex application for rate relief and for approval of other proposals. In the Commission's Order for Notice and Hearings of July 28, 1997, we described Columbia's application in some detail, and we divided the matter for further proceedings. The Commission determined that it would first consider the proposed Commonwealth Choice Program, which is a voluntary experiment using special rates under § 56-234 of the Code of Virginia. Commonwealth Choice would offer certain residential, small business, and industrial customers an opportunity to secure gas from suppliers other than the Company. Next, Phase I of this proceeding involved an application for approximately $8.539 million in additional annual revenues filed pursuant to §§ 56-235.2 et seq. of the Code of Virginia and the Commission's Rules Governing Utility Rate Increase Applications and Annual Informational Filings, 20 VAC 5-200-30. In our Order for Notice and Hearings, we referred this phase, along with the Commonwealth Choice Program's Stranded Costs Recovery Charge, to a hearing examiner for hearing. Finally, in Phase II of this proceeding, the Commission would consider the performance-based regulatory plan proposed by Columbia pursuant to § 56-235.6 of the Code of Virginia.

On February 9, 1998, the Commission entered its Order Granting Motion authorizing Columbia to withdraw the performance-based regulatory plan, which was to be considered in Phase II. That matter is no longer before us.

On September 30, 1997, the Commission entered its Order Approving Commonwealth Choice Program and authorized the pilot program through October 1, 1999. As discussed below, two issues remained outstanding concerning Commonwealth Choice.

Chief Hearing Examiner Deborah V. Ellenberg filed her Report on November 13, 1998 (hereinafter "Report"). She recommended that the Commission make certain findings concerning the application for a general increase in rates, Phase I, and the Stranded Costs Recovery Charge in the Commonwealth Choice

Program. In response to the Report, the Office of the Attorney General, Division of Consumer Counsel, Columbia, the Commission Staff, and several industrial protestants filed comments. The Commission has considered the Report, the comments, and the record developed herein. With the exceptions discussed below, the Commission adopts the Examiner's recommended findings. We will order Columbia to file an appropriate revised schedule of rates and charges, and to make promptly all necessary refunds.

## Commonwealth Choice Program

As noted, the Commission's Order Approving Commonwealth Choice Program of September 30, 1997, authorized the Company to commence this pilot program as a two-year experiment. Two issues remained outstanding. In our order of September 30, 1997, the Commission directed the Office of General Counsel and the Division of Energy Regulation to organize a task force to develop a proposed code of conduct for retail gas unbundling. The task force was directed to file a report by November 1, 1998. Subsequently, the Commission initiated other proceedings addressing unbundling programs in both the gas and electric industries. In our Order on Motion for Relief of December 4, 1998, in this Case No. PUE970455, we directed that all matters related to the establishment of the task force and the development of a generic code of conduct be addressed in Case No. PUE980812, Commonwealth of Virginia ex rel. State

Corporation Commission ex parte: In the Matter of Establishing Interim Rules for Retail Access Pilot Programs, established December 3, 1998.

The remaining issue in the Commonwealth Choice Program is the Stranded Costs Recovery Charge designed to recover the costs of Columbia's facilities stranded by the pilot program. In our Order for Notice and Hearings of July 28, 1997, the Commission referred the charge to the Hearing Examiner for development of a full record in conjunction with the hearing on Phase I, the application for a rate increase. In her Report, Examiner Ellenberg addressed the Stranded Costs Recovery Charge, and she recommended that the Commission reject the proposed charge. According to the Examiner, the record in this case does not support a finding of any stranded costs for the pilot program. In its comments on the Report, Columbia did not contest the Examiner's conclusions that there was an insufficient record to support the charge.[1]

The Commission will adopt the Examiner's recommendation that the stranded cost charge be disallowed at this time. As set out below, we will order Columbia to file revised tariff

[1] The Company did, however, object to the Examiner's conclusion that "'[s]tranded upstream pipeline capacity costs simply do not exist when a company is contracting for additional capacity.'" Comments and Exceptions of Columbia Gas of Virginia, Inc. at 19-20 (hereinafter "Columbia Comments"). Given our action in this case, we need not reach a decision on the Examiner's conclusion.

pages eliminating all reference to the Stranded Costs Recovery Charge. As the Examiner recommended, Columbia should continue to collect and report information on any costs that it considers stranded through the remainder of the pilot program. If Columbia believes it has incurred any stranded cost, the Company may request deferred accounting treatment from the Commission's Division of Public Utility Accounting.

## Phase I, Application for A General Increase In Rates

With the exceptions we discuss below, the Commission adopts the Examiner's recommended findings. We will also address briefly several issues raised during the proceeding.

### Consolidated Tax Adjustment

The Staff proposed a consolidated tax adjustment which the Examiner did not adopt. In our Order on Hearing Examiner's Report of December 22, 1998, in Virginia-American Water Co., Case No. PUE970523, the Commission rejected a similar consolidated tax adjustment, and we will not adopt the adjustment in this case. As in Virginia-American, a decision not to adopt the adjustment in this case does not rule out the possibility of adopting it in the future. As in Virginia-American, the Commission again declines to rule on the issue of whether the consolidated tax adjustment, as proposed by the Staff, constitutes retroactive ratemaking.

Restructuring Savings

The Examiner recommended that we adopt the Staff's proposal to reduce deferred restructuring costs by the restructuring savings that have not been reflected in prior rates. In its comments on the Report, Columbia argued that the Examiner had double-counted restructuring savings by netting these savings against the deferred restructuring costs. The Company claimed that restructuring savings were already recognized in the cost of service through lower employment levels and corresponding reductions in payroll and associated costs.[2] Further, Columbia argued that netting such savings through the updated period constituted retroactive ratemaking. In Columbia's view, the savings had already been reflected in earnings, and netting the savings deprived the stockholders of earnings previously recognized.[3]

The Commission does not agree with Columbia. The savings from restructuring that the Staff used to offset deferred restructuring costs have never been reflected in rates. The netting recognizes the entire financial impact of restructuring activities prior to the establishment of the regulatory asset, which will be recovered over time. It would be inequitable to ratepayers to defer all restructuring costs and not to recognize

[2] Columbia Comments at 15.

[3] Id. at 16.

the offset savings that occur over the same period. Restructuring savings recognized in the going level cost-of-service will impact rates on a prospective basis only. Reflecting this level of savings does not duplicate the impact of netting historical savings as proposed by the Staff.

Competitive Charges

The Staff proposed to eliminate from cost of service $97,651 of charges related to allegedly competitive activities. These activities included combustion adjustments on appliances and flue inspections on space heating equipment. The Company agreed that these charges should be booked below the line and not included in cost of service. Accordingly, the Examiner excluded charges for those services.[4]

We note, however, that in a case decided last year involving another gas company, the examiner rejected a similar Staff adjustment. Report of Deborah V. Ellenberg, Chief Hearing Examiner, Virginia Natural Gas, Inc., Case No. PUE960227, at 11-12 (Feb. 26, 1998). In that case, the adjustment had been contested by the utility. The examiner in Case No. PUE960227 found that the service calls at issue were proper responses to customer concerns over safety, and that costs associated with

[4] Of the $97,651 proposed to be eliminated from cost of service, the Examiner retained $33,413 because the Company identified two tariffed services associated with the latter amount recorded in the account in question. Report at 18.

such calls should be recovered by the company. This recommendation was adopted in our Final Order of April 27, 1998, in that case. In keeping with our decision in Virginia Natural Gas, the Commission will not accept the recommended adjustment in this case. The full $97,651 shall remain in Columbia's cost of service.

While we have determined to keep charges for certain inspection and maintenance services in the cost of service in this case and in Virginia Natural Gas, the Commission anticipates revisiting this issue in future proceedings. The nature of the gas distribution business is rapidly changing in the face of economic and regulatory developments. It is appropriate to reconsider what services should be provided by the regulated gas distribution company as part of a regulated retail distribution service. While a regulated company is entitled to a reasonable opportunity to recover the charges associated with any service it provides, the Commission expects to consider whether recovery should be above the line through tariffed rates for service and charges or below the line. Further, the Commission must be vigilant for over-recovery of any charges. We expect our Staff and the industry to consider these service and charge recovery issues in future proceedings and to develop a full record to support the development of future policies.

Rate Base

The Examiner recommended using an updated rate base to reflect actual per books levels as of September 30, 1997, as requested by the Company in its original application. As the Examiner noted, Columbia proposed updating rate base through December 31, 1997, in rebuttal testimony, less than one month prior to the commencement of the hearing. The Examiner found that the corresponding increase in revenues related to customer growth associated with the plant additions was not included in the record and that updating rate base without reflecting increased revenues would be improper. In its comments to the Examiner's Report, Columbia strongly excepted to the Hearing Examiner's recommendation, arguing that the revenue adjustment was, in fact, provided. However, the record provides only the revenue adjustment amount—with no supporting documentation.[5] The Commission's rules require that supporting documentation for company proposed adjustments be filed with the application.[6] The standard cannot be less for a later proposed adjustment.

The Commission adopts the Examiner's findings that the per books rate base as of September 30, 1997, is appropriate and supported by the record. As the Examiner acknowledged in her

[5] Furthermore, no supporting documentation was provided for update-related adjustments to property tax expense and depreciation expense.

[6] See Schedule 17 of the Commission's Rules Governing Utility Rate Increase Applications and Annual Informational Filings, 20 VAC 5-200-30.

Report and as Columbia argued in its comments, the Commission has previously allowed updating rate base to reflect significant plant additions made after an application was filed. Here the Company's proposal was not subject to sufficient examination because of the timing of the proposal and the lack of supporting documentation.[7]

In addition, it must be clear that changes such as proposed by the Company here cannot be allowed on a regular basis. The addition of new adjustments or updating by a company after the application has been filed should be allowed only in unusual circumstances where good cause is shown; where such changes are necessary to protect the financial integrity of the company; and where the supporting data is provided and can be fully examined by the parties and Staff in the proceeding. Absent this rare exception, the company must present its entire case in its application and direct testimony. If a company's rate request must be reduced after the application is filed, the company cannot simply find another adjustment or update to increase the request to the original amount noticed.

Earnings Test

The Staff proposed application of an earnings test incorporating its consolidated tax adjustment. The Examiner

[7] Further, in the absence of a full examination, allowing these kinds of adjustments tends to isolate single cost elements without considering circumstances that might offset them.

adopted the earnings test after adjusting for the consolidated tax adjustment which she and we have rejected. At the hearing and in its comments on the Report, the Company challenged the methodology used in the earnings test. Upon consideration of the record and the Report, the Commission finds that the Staff's proposed earnings test conforms to the guidance and standards set out in the Final Order of August 6, 1998, in Roanoke Gas Co., Case Nos. PUE960102 and PUE960304, and in the Final Order of August 6, 1998, in Washington Gas Light Co., Virginia Division, Case No. PUE970328.

Return on Equity

We agree with the Examiner that the use of the consolidated Columbia Energy Group capital structure as of September 30, 1997, (with a ratemaking equity ratio of 45.17%) is appropriate and is supported by the record. We also agree that Columbia Gas of Virginia's return on equity, absent a financial risk adjustment, is within a range of 10.25% to 11.25%. Our decision on an appropriate financial risk adjustment requires additional discussion.

Columbia and Staff recommendations on the appropriate return on equity were linked to various capital-structure equity ratios. The Staff recommended a return-on-equity range of 10.0% to 11.0%. The Staff's cost of equity analysis was based on two proxy groups: a 16-company group that served as a starting point and a check against a smaller, more homogeneous, 5-company proxy group.[8] The large group had an average equity ratio of 52.8%, while the Staff's five-company proxy group had an average equity ratio of 49.3%.[9] According to the Staff, the difference between the consolidated Columbia Energy Group equity ratio of 45.17% and its 5-company proxy-group average equity ratio of 49.3% was not significant enough to warrant a financial risk adjustment.[10]

The Staff has in the past recommended financial risk adjustments. In the Final Order, Virginia Natural Gas Inc., Case No. PUE960227, at 8-9 (Apr. 27, 1998), the Commission discussed a downward financial risk adjustment proposed by the Staff to reflect the lower financial risk of the parent company capital structure. As the examiner in Case No. PUE960227 noted, the Staff had relied, in part, upon a study that "determined that the cost of equity changed, on average, 7 basis points for each percentage point change in the common equity ratio."[11]

The Company proposed a return-on-equity range of 10.5% to 11.5% based upon an adjusted Columbia Energy Group capital structure with an equity ratio of 52.2%. The Company's

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[8] Ex. LTO-28 at 16-18, Schedules 6-9.

[9] Report at 24.

[10] Tr. at 594-96; Ex. LTO-29.

[11] Report of Deborah V. Ellenberg, Chief Hearing Examiner, Virginia Natural Gas, Inc., Case No. PUE960227, at 18 (Feb. 26, 1998) (footnote omitted).

recommendation was based upon a proxy group with an average equity ratio of 52.7%. On rebuttal, the Company argued that, if the Staff's proposed capital structure with a 45.17% equity ratio were adopted, the Commission should adopt a return on equity of 11.7% to reflect the added financial risk.[12] In making its financial risk adjustment recommendation, the Company relied upon a 1972 study by Robert Hamada.[13]

In the current case, the Hearing Examiner agreed with the Company that a financial risk adjustment was warranted. She recommended that the Company be granted a 25-basis point adjustment. In making her recommendation, the Hearing Examiner cited several cases in which the Commission has awarded both upward and downward adjustments. She also noted that, "The equity ratios previously approved for Columbia, those of the CDC group, and those of the comparable companies included in Staff and Company's analyses range from 49% to 53%."[14]

The Company seems to argue in its Comments and Exceptions that financial risk adjustments can be made with precision. The Company stated that the Hearing Examiner's 25-basis point

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[12] Ex. JRH-48 at 9.

[13] Robert Hamada, "The Effect of a Firm's Capital Structure on the Systematic Risk of Common Stock," 27 J. of Finance 435 (1972).

[14] Report at 27.

adjustment was "arbitrary and capricious"[15] and that "the adjustment necessary to compensate a company for which 52.8% is the appropriate equity ratio but for which the Commission adopts an equity ratio of 45.17% is 61 basis points."[16] The Company also claimed to be "mystified" by the Examiner's 25-basis point adjustment. Columbia stated that, "[t]here is not a scintilla of evidence in the record that suggests 25 basis points reflects the company's additional financial risk" because of the equity ratio.[17]

The Company's statements concerning the Examiner's analysis and the 25 basis point financial risk adjustment are incorrect. Factually and legally, there is credible evidence to make no adjustment; to choose the Company's proposed 61-basis point adjustment; or to select a point in between.[18] In addition, and just as importantly, the theory of such an adjustment and its practical use does not lend itself to the precision argued by the Company. The Company's witness, Dr. Haltiner, stated this well in his direct testimony:

> Let me add one note of caution in the use of Hamada's leverage adjustment model and other models. These equations appear as precise

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[15] Columbia Comments at 2.

[16] Id. at 7.

[17] Id. at 6.

[18] See Appalachian Power Co. v. Commonwealth, 216 Va. 617, 626-28 (1976).

> mathematical statements. However, there are numerous assumptions underlying their development. In the leverage adjustment model in Attachment JRH-16, for example, Hamada assumes, consistent with CAPM assumptions, that a company can borrow at the riskless rate in perpetuity. A model is helpful in guiding our thinking about the effects of various forces affecting investor expectations, but model results taken literally, without the opportunity to apply judgement, can be misleading.

Ex. JRH at 32.

We further note that it appears that Columbia's adjustment relied upon a model that re-leverages beta, which is unique to CAPM. Both Staff and Company witnesses utilized the results of the DCF model and risk premium methods, in addition to the CAPM, to estimate the cost of equity. All methodologies used to estimate the cost of equity have strengths and weaknesses. The results from all three methods, along with informed judgement, should be considered to estimate the cost of equity. We thus cannot conclude, as the Company urges, that the equity return is subject to a precise 61-basis point adjustment.

Based on the record in this case and our judgement, however, we believe that the 25-basis point adjustment recommended by the Examiner should be increased. Specifically, we find that the starting point for the return on equity range of 10.25% to 11.25% should be adjusted upward by 40 basis points to account for the differences between the various proxy-group equity ratios and the consolidated Columbia Energy Group equity ratio. In doing so, we do not adopt a specific formula for establishing an adjustment to the range for return on equity. Rather, we find at this time, that the record supports a 40-basis point adjustment. Based upon the record in this case, we find that a return on equity range of 10.65% to 11.65% is appropriate, and that the midpoint of 11.15% should be used for setting rates.

Propane Services

In its comments, Columbia objected to the Examiner's recommendation that its existing Metered Propane Service ("MPS") be closed to new customers, and that its proposed Propane Delivery Service ("PDS") be modified to require conversion of customers to natural gas within two years. In Columbia's last rate case, the Commission approved a stipulation placing a moratorium on the addition of new MPS customers. The moratorium was imposed because the Company was not converting those customers to natural gas within a reasonable period.

MPS is offered under the same rate structure as residential natural gas service. Since propane is generally more expensive than natural gas, MPS is effectively subsidized by the Company's other customers. This subsidy is particularly disturbing in that the record demonstrates that, without limitations, Columbia has taken seven to eight years to convert MPS customers to natural gas, and that some customers remain on propane even longer. Therefore, we will adopt the Examiner's recommendation that MPS be closed to new customers. Existing MPS customers shall be "grandfathered" under that schedule.

While we are concerned over the subsidy to the MPS service and the delays in converting MPS customers to natural gas, we note that the record does not include any information with respect to the cost effectiveness of converting the remaining MPS customers to natural gas. We will not, therefore, mandate a specific conversion period for the current MPS customers now grandfathered under that schedule. Instead, we direct Columbia to conduct a study to determine the cost effectiveness of converting each remaining MPS service to natural gas service. This study should consider the impact of conversion on overall purchased gas costs as well as on Columbia's non-gas revenue requirements. Should such study show that it is impractical to convert the remaining MPS installations within a reasonable period of time without additional charges to the grandfathered customers, Columbia should submit information as to why it should be allowed to continue recovery of the MPS subsidy from customers.

We would like to consider and resolve this issue in the context of the Company's pending rate case. By companion order entered today in Case No. PUE980287, we direct the presiding hearing examiner to enter an appropriate ruling for the filing of supplemental testimony addressing these issues.

As noted, Columbia objects to the Examiner's imposition of a two-year requirement for conversion to natural gas under the new PDS service. We believe that customers who take service under the PDS schedule should do so with an expectation that they will be converted to natural gas within a reasonable period of time and will adopt the Examiner's recommendation in this regard.

## Conclusion

The Commission makes the following findings based on the record in this proceeding:

1. The use of the test period ending December 31, 1996, is proper in this proceeding;

2. The Company's test year operating revenues, after all adjustments, were $170,245,173;

3. The Company's test year operating revenue deductions, after all adjustments, were $151,341,356;

4. The Company's test year net operating income and adjusted net operating income, after all adjustments, were $18,903,817 and $18,678,019 respectively;

5. The Company's adjusted test year rate base is $240,710,581;

6. The Company's current rates produce a return on adjusted rate base of 7.76% and a return on equity of 8.48%;

7. The Company's current cost of equity is in a range of 10.65% to 11.65%, and the Company's rates should be established based on the midpoint of the equity range, 11.15%;

8. The Company's overall cost of capital, using the midpoint of the equity range and the capital structure found reasonable herein, is 8.96%;

9. The Company's request for an annual increase in revenues of $7,941,578, as proposed at the hearing, is unjust and unreasonable because it would generate a return on rate base greater than 8.96%;

10. The Company requires $4,607,122 in additional gross annual revenues to earn an 8.96% return on rate base;

11. Rates designed to produce the additional revenues found reasonable herein shall use the revenue apportionment methodology agreed to by the parties and accepted by the Examiner;

12. The tariff changes accepted by the Examiner and addressed in the Report shall be made.

ACCORDINGLY, IT IS ORDERED THAT:

(1) Columbia's application for a general increase in rates, designated as Phase I of this proceeding, is granted to the extent discussed herein and otherwise denied.

(2) Columbia's application to include the Stranded Cost Recovery Charge in the Commonwealth Choice Program is denied.

(3) On or before March 1, 1999, Columbia shall file with the Commission's Division of Energy Regulation a schedule of rates and charges designed to produce $4,607,122 in additional gross annual revenues and bearing an effective date of March 1, 1999, and effective for service rendered on and after that date. The additional revenue shall be apportioned using the methodology approved herein and incorporating the changes in rates, schedules, rules and regulations approved herein.

(4) All references to the Stranded Cost Recovery Charge in the Commonwealth Choice Program appearing in the schedules of rates and charges now on file with the Commission shall be removed from the revised schedule of rates and charges ordered to be filed in (3) above; all other matters appearing on tariff pages governing the Commonwealth Choice Program shall appear on the pages filed as ordered in (3) above.

(5) On or before April 1, 1999, Columbia shall recalculate, using the rates and charges prescribed by this Order, each bill it rendered that used, in whole or in part, the rates and charges that took effect on October 7, 1997. Where application of the rates prescribed by this Order results in a reduced bill, Columbia shall refund, with interest, as directed below, the difference.

(6) Interest upon the ordered refunds shall be computed from the date payments of monthly bills were due to the date refunds are made, at the average prime rate for each calendar quarter, compounded quarterly. The average prime rate for each calendar quarter shall be the arithmetic mean, to the nearest one-hundredth of one percent, of the prime rate values published in the Federal Reserve Bulletin or in the Federal Reserve's Selected Interest Rates (Statistical Release G.13) for the three months of the preceding calendar quarter.

(7) The refunds ordered in (5) above may be credited to current customers' accounts (each refund category shall be shown separately on each customer's bill). Refunds to former customers shall be made by check mailed to the last known address of such customers when the refund amount is $1 or more. Columbia may offset the credit or refund to the extent no dispute exists regarding the outstanding balance of a current or former customer. No offset shall be permitted for the disputed portion of an outstanding balance. Columbia may retain refunds owed to former customers when such refund amount is less than $1. Columbia shall maintain a record of former customers for which the refund is less than $1, and such refunds shall be made promptly upon request. All unclaimed refunds shall be subject to § 55-210.6:2 of the Code of Virginia.

(8) On or before June 1, 1999, Columbia shall file with the Division of Public Utility Accounting a report showing that all refunds have been made pursuant to this Order and detailing the costs of the refund and accounts charged. Costs shall include, inter alia, computer costs, and the personnel hours, associated salaries and costs for verifying and correcting the refunds directed in this Order.

(9) This case is dismissed from the Commission's docket.

MOORE, Commissioner, concurs in part and dissents in part:

I concur with my colleagues, except with respect to the consolidated tax adjustment ("CTA"). I find that I must dissent with respect to that finding for the reasons I discussed in my dissent in Case No. PUE970253, Virginia-American Water Co. Adopting the CTA would more accurately reflect Columbia's cost of service; I would do so on a prospective basis.